See also:

commodity power; diplomacy, economic; power; sanctions, economic; structural power

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economic realism

Economic realism is one of the three major approaches used to assess and understand developments in the international economy. Specifically, economic realism provides a framework alternative to the standard neo-classical and Marxist models (see MARXIAN ECONOMICS; NEO-CLASSICAL ECONOMICS) for identifying the underlying forces and dynamics of the world economic system. Much of the recent economic realism literature has its origins in the earlier works of David Calleo and Benjamin Rowland (1973), Robert Gilpin (1975, 1987) and R.J. Barry Jones (1986). Jones notes that the economic realist approach derives its name from the fact that it reflects and accommodates the complex set of realities exhibited by the empirical world. While the neo-classical approach is much more analytical and sophisticated, to many people that approach's over-reliance on market solutions provides little insight into the real factors at play in the international system. To realists, such an approach is of extremely limited value for providing concrete policy recommendations.

Antecedents

As the liberal approach evolved out of micro-economic theory and the literature on free-market capitalism, economic realism evolved out of the STRUCTURAL REALISM school of international relations (IR) and the mercantilist school of international trade (see MERCANTILISM). Structural realism makes the following set of assumptions: states (see STATE, THE) are the key actors in IR; states interact in an anarchic environment devoid of rules and enforcers, and (as a consequence of anarchy) much of their behaviour is shaped by the possibility of war and the necessity of preparing to deter or defeat military challengers. The threat of war leads each state to maintain its own defence capabilities and to form loose alliances whenever possible with states that share common defence interests. Although structural realists disagree about foreign policy prescriptions that can be derived from the theory, the following are broadly accepted:

1 States tend to balance against military threats, not bandwagon with them. Secondary states (if they are free to choose) flock to the weaker side, as it is the stronger side that threatens them.
2 States prefer to maintain independent

military capabilities. Although states will form loose military alliances in order to balance against primary threats, they will guard themselves against the possible defection of allies by maintaining a full array of military forces and will resist the specialization of their military forces in the interest of greater alliance rationality.

3 Powerful states are more prone to follow Predictions 1 and 2 than are weak states.

While the IR school of realism has been largely silent on economic issues and on how economic and military security concerns relate to one another, the following propositions capture the basic thrust of their arguments: States will be highly sensitive to the relative economic gains of other states they consider military threats. Realists agree that less trade will occur than is rational from a classical economic standpoint. Given that trade may benefit one partner relatively more than the other and that trade involves the specialization of labour between states, states will restrict trade in order to avoid shifts in the balance of power or dependency on trade partners for goods that may be critical in the event of war.

The trade-inhibiting effects of differential benefits from trade will be muted within alliances and between partners that are not potential military competitors. The greater the perceived military threat to a state, the more that state will pay in order to maintain its alliance relationships. How the costs of a military alliance will be divided among component members will be affected by the relative military dependence of the states involved. When a state faces both a high degree of military threat and the possibility of defection by allies, it will pay relatively more to entangle its partners and reduce the likelihood of abandonment.

Economic (mercantilist) realism draws on structural realism to derive a series of propositions about the conduct of state affairs in the economic realm. Here the key idea is that TECHNOLOGY and national wealth should be given prominence in providing security. This line of thought has its antecedents in the nineteenth-century neo-mercantilist propositions of ALEXANDER HAMILTON and FRIEDRICH LIST (see NEO-MERCANTILISM) and the mid-twentieth-century insights of JOSEPH SCHUMPETER, E.H. CARR and ELI HECKSCHER. Hamilton and List stress that states must nurture their manufacturing capacity to remain strong; Hecksher and Carr maintain that states can use economic power to unify and dominate the system within their sphere, and Schumpeter argues that innovation is the most dynamic source of structural change and power in capitalist economies.

Initially, the common purpose of mercantilist measures was to promote the strength and potential power of the state and its ruler(s) against other communities with which conflicts of interest (and of arms) might develop. Classical mercantilism was seen to be primarily bullionist (see BULLIONISM), with policy being directed towards the accumulation of bullion, specie and all other readily transportable forms of wealth that might be used for recruiting and sustaining armed forces. Later classical mercantilism broadened its vision to include the promotion and protection of society's general economic strength and capacity, and the establishment of a strategically advantageous balance of trade with other states.

Although traditional mercantilists and classical realists have been concerned largely with the connection between national wealth and national military power, the policies designed to enhance the technological and economic fortunes of states may be pursued to increase a state's political leverage and independence, even in the absence of military–security considerations. In developing predictions consistent with a mercantile version of realist theory, the literature generally assumes that broad segments of the elite in some states might embrace three ideas: (1) the possibility that the efficacy of appeals to arms has, for a variety of reasons, declined dramatically during the course of the twentieth century; (2) national economic power can be used to constrain the sovereignty or independence of states, and (3) national economic power can be enhanced through industrial and trade policies designed

to create COMPARATIVE ADVANTAGE in critical high-technology sectors.

In its classical formulation, REALISM was a comprehensive theory about state behaviour. Only during the COLD WAR did it become closely associated with the more narrow logic of military competition. At its core, classical realism is a theory of the state and international competition. It is not primarily a theory about how states acquire security or about defence issues. In fact, the best treatments of realism's intellectual roots are not found in the security side, but rather in its more overlooked economic philosophy of mercantilism.

Despite differences in goals, structural and economic (mercantile) realism have several elements in common. Each is 'realist' because each posits states as the most important actors in world politics; each assumes that state behaviour is determined by rational national leaders seeking to maximize state power, and each suggests a competition among states for relative power and security. Despite sharing core elements, economic (mercantile) and structural realism produce divergent predictions under many global and regional political conditions. These differences involve more than differential rates of military investment or trade policies. They comprise a broad range of preferences, including the question of how elites define threats and select allies, as well as how they conduct themselves with stakes that they find threatening and those they find non-threatening.

Several propositions associated with economic (mercantile) realism illustrate how this approach differs from those of structural realism: (1) security threats are economic, as well as military; (2) powerful techno-economic states will balance against other techno-economic states; (3) when trade-offs must be made, techno-economic interests may be pursued at the expense of political–military interests, and (4) the nationality of firms matters as much as or more than the location of production.

Under structural realism, the primary threat to state security is from direct attack. The equivalent to military conquest in mercantile realism is DEINDUSTRIALIZATION or dependency. States that intervene in their national economies to nurture domestic producers are acting to protect domestic markets from the economic equivalent of direct attack; we would thus expect states to justify these interventions as matters of national security that will therefore entail the sorts of national mobilization and sacrifice associated with military mobilization elsewhere. It follows that such states should be particularly sensitive to technological dependency.

Given that technological capabilities are essential for prosperity in industrial economies, timely access to technology is a matter of national security. The dangers of excessive dependence are measured as more than 'vulnerability' to access denied; there are opportunity costs of foregone chances to learn and to innovate. Economic (mercantile) realists will also worry about exploitation by technological leaders who would use their market power to influence purchases, to rent-seek (raise prices – see RENT SEEKING), to extort by allocating or denying supplies for strategic reasons, and to be predatory by driving another nation's producers from the market entirely. Economic realists refer to the consequence of such dependency: the reduction of national firms to assemblers, handlers and retailers unable to reap the full profits of manufacturing and innovation.

States may balance both economically and politically against rival industrial powers even when those nations pose little military threat; conversely, close economic and political relations may be pursued with states possessing complementary economies, even when such behaviour entails some degree of future military risk. States may adopt a wide array of measures, including strengthening ties with economically less-threatening partners, in order to mitigate this danger. As in structural realism, balancing behaviour is most likely to characterize the behaviour of major industrial states. Technologically weak states may have little choice but to integrate their economies ('bandwagon') with the dominant partner. The economic bloc that would ensue is the

mercantile realist analogue to the military alliance in structural realism. Under economic realism, states will also balance against others based on judgement of their strength, position and behaviour, but these judgements will conform to a techno-economic logic.

Strength in the mercantile world is not always determined by size, population or military capability, but also sometimes by wealth and technology. While these have hardly been unrelated historically, they are not always co-variant and should be distinguished analytically. Economic realists will balance against wealthy states that are endowed with technology-intensive industries.

Position in the mercantile world is defined by its industrial structure, rather than by its physical geography. States that compete in the same sectors will tend to view one another as threatening and mercantile realists will minimize intra-industry trade. While military strengths rapidly attenuate across space, technological power and the ability to profit from it are not. Hence, in the context of global markets, states far away may pose as big a threat as those that share common borders.

States will balance against others that behave as economic predators. Moreover, because the behaviour of other states may be misinterpreted under mercantile realism, just as it may in the world of structural realism, we can imagine the problem of techno-economic 'security dilemmas' in which defensive efforts made by one state (for example, to protect infant industries) may be viewed by trading partners as aggressive actions to which they might respond with tariffs and other sanctions.

Nations may be forced to choose between maximizing techno-economic values or maximizing political-military values. Structural realists argue that when forced to make this choice, states will seek to achieve political-military goals first. Military security is like oxygen, they assert: it is taken for granted until there is too little of it, at which point, states will do anything to get more. Economic realists respond that economic security is just as important, adding that once economic security is gone, it is difficult to recover (see SECURITY, ECONOMIC). A state with a powerful technological and industrial base is capable of transforming itself from a military pygmy into a military giant within a short span of time, whereas states with large militaries that allow their industrial and technological base to wither find themselves in a more difficult predicament. They may thus be unable to protect themselves from either economic coercion or military threats.

Even in a global economy, economic realists assume that firms have (and will retain) a national centre of gravity. States therefore seek not only to nurture firms within their borders, but also to support national firms abroad. These firms are more comfortable trading with co-nationals sited abroad than they are with foreign-owned entities at home. It follows that outward FOREIGN DIRECT INVESTMENT (FDI) can be used to entangle allies and to create dependence that serves national ends, while inward direct investment can be carefully monitored and circumscribed to prevent the same result. Under structural realism, the physical location of production may be more important, because production assets may be nationalized in the event of war.

Modern neo-mercantilism

The main thrust of modern-day economic realism extends the original mercantilist ideas to today's realities. The school's main assertion that aggressive government actions – including STRATEGIC TRADE POLICY, INDUSTRIAL POLICY and TECHNOLOGY POLICY – will bring about increased national 'competitiveness' overseas. In the United States, leading proponents of this view include such academic economists as Paul Krugman and Lester Thurow at MIT, and John Zysman and Laura Tyson (formerly chair of the Council of Economic Advisors) at Berkeley, and numerous well-known commentators, including Clyde Prestowitz, James Fallows, Chalmers Johnson, Pat Choate and Karel van Wolferen.

'Industrial policy' and 'strategic trade policy' differ from one another in some respects. Industrial policy focuses on the development of

key domestic industries and technologies, with international trade accorded a secondary role. Strategic trade policy focuses on international trade, on promoting specific exports and limiting specific imports. Strategic trade policy includes, as well, the use of threats and the imposition of penalties to pry open foreign markets. A recent example is the US threat to impose high countervailing tariffs on Japanese imports – by reactivating the SUPER 301 provision of the trade legislation of 1988 – unless US exports of cars and auto parts reach certain specified shares of Japan's domestic market for these products.

Nevertheless, despite the differences between strategic trade policies and industrial policies, they share a fundamental premise: government should select certain industries, technologies and firms whose advancement is of 'critical' importance for the economy as a whole, and accord the selected ones some form of preferential treatment – whether through SUBSIDIES, tax advantages, import restrictions, special efforts to promote exports, or direct government financing for 'pre-commercial development' of putatively critical technologies. To some, 'critical' means high-technology industries in general; to others, it means this as well as certain specific sectors, such as semiconductors, or telecommunications, or cars, or machine tools, or even rice. In the interest of simplicity, both sets of policies are often referred to as 'preferential industrial and trade policies' (PITP).

The intellectual basis for PITP rests on several well-established economic precepts: first, ECONOMIES OF SCALE – the notion that large firms can realize certain efficiencies not accessible to small ones – and, second, economies of learning – the notion that individuals and firms that have acquired abundant experience are more efficient than those with less.

A corollary of these gains is the existence of certain spill-over benefits (EXTERNALITIES), that are presumed to accrue to other industries or to the economy as a whole. These externalities – benefits external to the firm or industry generating them, and not susceptible to its control or exploitation – may be of several types and may arise in various ways. For example, if a firm or industry achieves substantial size, it may provide a large market that redounds to the advantage of feeder industries, firms and suppliers. Thus the large size of the automotive industry provides opportunities for electronics, tyre, lighting and other component producers that, in turn, enable them to increase their own efficiency through larger-scale production. Economists refer to these spill-overs as 'pecuniary externalities'.

Another type of spill-over – referred to as 'technological externalities' – may result from the experience, learning and accumulated know-how of the originating firm or industry, and the more highly skilled labour pool that is thereby created, with potential benefits for other firms or industries. The development and remarkable growth of the internet, as a result of linking computers and telecommunications, provides a striking example of technological externalities that hugely benefit international business, finance and commerce.

Economic realists often assert that in such technology-intensive industries, costs fall and product-quality improves as the scale of production increases, and the returns to technological advance create beneficial spill-overs for other economic activities. Economies of scale are typically represented by unit costs that decline as the scale of output increases. Economies of scale are traceable to the increased opportunities of large firms for division of labour and specialization of tasks, and for spreading fixed costs over a larger volume of output as production rises. Thus, supermarkets typically can under-price small grocers and profit from doing so. And, at least until recently, it has been presumed that large-scale steel-makers, such as USX or Kobe, can out-compete small steel producers because of the economies of scale the larger firms can realize.

'Economies of learning' – that is, efficiencies resulting from accumulated experience – are also presumed to result in lower costs, and to yield a competitive advantage for firms that have been in business for a long time.

Economists use various proxies to measure experience: for example, the cumulative output of individual firms or the cumulative years they have been in business. The premise underlying these proxy measures is that the greater the cumulative output or the greater the number of years of experience, the more proficient will be the firm's operations and the stronger its competitive position relative to less experienced firms. Thus IBM, General Motors and Toyota have been presumed – at least in the past – to derive a competitive advantage from their accumulated learning and experience.

Economies of scale and learning, plus the corollary externalities with which they are associated, provide the intellectually respectable ideas that have led many to accept the case for strategic trade and industrial policy. Because of these economies, it is argued, government should establish one or another type of preference or subsidy to establish a lead in an industry, and once this lead is established it becomes self-reinforcing and tends to persist.

Criticisms

From the discussion above it might appear that adaptation of the lessons of economic realism to modern economic problems would be fairly straightforward. As noted above, economic realists begin with the notion that economic activity is a source of power and, in a world in which military conflict between major states is unlikely, economic power will be increasingly important in determining the primary or subordinate states. Still, the strong theoretical arguments in favour of preferential industrial and trade policies confront equally powerful arguments in opposition. PITPs are also criticized for normative, empirical, as well as theoretical reasons. Large size and accumulated experience confer initial advantages, but may entail later, offsetting disadvantages. This suggests there may be an optimum size – large, but not too large – and an optimum degree of experience – some, but not too much – for maximum competitiveness. While some scholars attribute the recent economic success of Japan and the NEWLY INDUSTRIALIZED COUNTRIES (NICs) of Asia largely to PITPs, others attribute it to low wage and inflation rates, rapid copying of the product and process technologies of competitors, high domestic savings rates (enabling low interest and high investment rates) and undervalued currency exchange rates, to name just a few of the possible alternative explanations.

The normative critics focus on the dangers of giving too much power to the state. Classical liberal and neo-classical economists argue that the state should be restrained from asserting its authority in new areas of the economy unless there is no other way to resolve market failures. Critics question particularly the need for strategic intervention to increase economic welfare. Consider a situation in which a state identifies a set of strategic industries and provides them with an export subsidy. Suppose that such strategic industries compete for the same scarce factors. In this case, state support drives up the prices of the scarce factor (a pecuniary externality) and none of the industries benefit. Furthermore, if equity is also an objective of state policy, then such interventions will skew the income distribution in favour of the scarce factor.

Critics also point out that PITPs can advance the interests of a particular country only if other countries do not retaliate by providing matching supports to their domestic firms and industries. If such retaliation occurs, then the relative gains promised by PITPs may not materialize. It is also suggested that special interests will abuse the willingness of governments to intervene. Firms, as rational actors, have incentives to externalize their problems to avoid painful internal restructuring. Such firms can therefore be expected to lobby for state support. It will therefore be difficult to separate strategic interventions from non-strategic interventions.

Many scholars question the ability of governments to effectively implement PITPs. They consider PITPs to be similar to infant-industry and import-substitution policies (see IMPORT SUBSTITUTION; INFANT INDUSTRY PROTECTION), encouraging rent seeking and leading to misallocation of resources. One of their

concerns is that it is difficult, *ex ante*, to specify which industries are strategic. That is, in part, related to the difficulties in measuring externalities. In the absence of reliable objective measures of externalities, political rather than economic criteria may dominate the choice of strategic industries.

Strategic innovations have to be focused on industries with super-normal profits and states often have only limited ability to identify such industries. Furthermore, it is difficult to determine whether a particular level of profit is super-normal. Imperfect competition also does not *per se* signal super-normal profits, since competition among a few rival firms can be fierce enough to drive the prices down to competitive levels. Also, PITPs require that the national firms be clearly distinguished from foreign firms and that polices be targeted to benefit national firms only. However, in a global economy it is often difficult to distinguish between national firms ('us') and foreign firms ('them').

PITPs are most effective in creating competitive advantage if technology is not mobile across national boundaries. However, technology flows across national boundaries are growing with the help of innovative institutional arrangements such as joint research ventures, technology exchange agreements, customer–supplier relationships and so on. Critics argue that PITPs cannot explain how domestic firms become R&D leaders in the absence of government assistance, or how state-assisted industries failed in the face of massive assistance. Hence, they argue PITPs can at best be only facilitating conditions for the success of domestic firms.

Scholars also point out that there are different forms of capitalism and that only some forms are consistent with strategic interventions. An important research question is whether some countries are more willing and capable of using PITPs than others. The United States has rarely engaged in strategic interventions in the past, partly because of the ideological and institutional acceptance of neo-classical economics. On the other hand, since neo-classical ideas are less influential in Japan, the Japanese state faces less opposition to its interventionist role.

PITPs do not show instantaneous results: their effects are usually visible after considerable time-lags, sometimes longer than electoral cycles. The successful implementation of PITPs requires that firms believe that state support will continue irrespective of political change. Can every state make such credible commitments? If we classify states as regulatory or developmental, it is usually conceded that regulatory states have minimal capabilities for strategic interventions, and their polices seek to ensure an unfettered working of markets and a correction of market failures wherever they arise. DEVELOPMENTAL STATES, by contrast, are capable of adopting PITPs and are willing to stick with them, even in the face of temporary difficulties.

The nature of domestic socio-political institutions – such as the relative autonomy of the state from domestic interest-groups, the transparency of domestic decision-making, and social and political cohesiveness – critically shape firms' perceptions of state commitments. For example, if political power is dispersed domestically, then it may be difficult for the government to make credible commitments. In a relatively decentralized federal system, the executive may face strong opposition from provincial governments, as well as from the national legislature and competing bureaucracies, and therefore may not be able to sustain its interventionist policies. Thus one would expect countries with centralized and bureaucratic (and therefore relatively autonomous) political regimes to be more likely to adopt and sustain PITPs.

Are developmental states always more credible in providing such assurances or are they credible only in some phases of economic growth? Here the literature identifies four phases of ECONOMIC GROWTH: factor-driven, investment-driven, innovation-driven and wealth-driven. PITPs are linked with the investment-driven phase, in which the developmental state actively facilitates economic growth. State support may in fact constitute a credible commitment to deter foreign competitors from engaging in predatory strategies

such as reducing prices to drive domestic competitors out of business. However, in the innovation-driven phase of growth, the micro-management of the economy of the developmental state is counter-productive, since bureaucrats seldom have the information needed to correctly pick winners. In this phase, the regulatory state (which does not undertake PITPs) may provide a more appropriate institutional setting, since it focuses on providing macro-economic stability, guaranteeing INTELLECTUAL PROPERTY RIGHTS (IPRs) and preventing inefficiencies caused by imperfect competition.

Alternative neo-mercantilist agendas

The objections to PITPs noted above suggest neo-mercantilist policies focused in this direction may not be appropriate for many countries. This being the case, economic realism will have to be tailored to fit individual economies and situations before it will gain wide acceptance in the academic and policy communities. In addition, it appears that a number of macro-economic initiatives may be more effective then micro-economic initiatives or related PITPs at attaining the economic realist's national objectives. For example, looking at the United States, Theodore Moran (1993) asks: what economic policies will in fact foster the pursuit of primacy? What economic policies would, in contrast, lead to the redistribution of power in favour of rivals of the United States, complete with the hostility and antagonism of earlier big power struggles? In short, what is the economics agenda best suited for an economic realism approach to policy-making? Is there a special policy-path, perhaps built around strategic-trade theory, for those who wish to pursue relative gains at the expense of mutual gains, or political power at the expense of economic welfare?

Writing in the early 1990s, Moran suggested that an economics agenda for US neo-realists should address three principal dangers to that country's position in the international political system that emerged directly from US economic policy: a persistent imbalance in trade and capital accounts that mortgaged the assets of future generations or turned the assets of the current generation over to foreigners; a lagging competitiveness of firms and workers that undermined the growth rate and skill level of the nation's industrial base (and other sectors) in comparison to rival states; a growing dependence on outsiders for critical products or technologies, which left the nation vulnerable to denial or manipulation by external suppliers.

The neo-mercantilist approach would approach balance-of-payments disequilibrium by attempting to force other nations to open their markets, or pushing especially forcefully for domestic controls on investment flows. However, as Moran correctly notes, the method to stop the foreign build-up of obligations against US assets is, despite the appearance of the words 'trade' and 'investment', purely a macro-economic issue involving domestic consumption versus domestic savings. As long as a country consumes more than it produces, it will experience a trade deficit and a corresponding reliance on foreigners to finance it. Trade protection and investment restrictions, strategic or otherwise, cannot alter this; neither can vigorous efforts to open up external markets for products of capital. Trade policies and regulations for investment can affect the composition of the imbalances, but not their magnitude. Change in magnitude can only be accomplished by altering the country's internal consumption/savings ratio.

The second threat to America's position in the international system – weak growth in the performance of American firms and workers in comparison to the corresponding growth in the performance of foreigners – also calls for a inward-oriented macro-economic solution – increasing indigenous investment in plant and equipment, human capital and new technology.

With regard to the neo-realists' final objective of avoiding dependence on foreigners for critical products and technologies, exclusive use of strategic trade policies might also be somewhat self-defeating, leading to provocation, escalation and retaliation from the major industrial nations. Specifically, an approach

that consciously uses market intervention to capture a significant share of the most vital high-tech industries for one's own country, if legitimated for any particular state becomes a fair game for all states. Instead, a neo-realist agenda might consider mixed-nation participation in public R&D programmes, regulation of foreign acquisitions in critical industries via performance requirements for local production (not prohibition of the acquisition itself), encouragement of transborder corporate alliances and harmonization of anti-trust surveillance (competition policy) across national jurisdictions. Here the goal would be to diversify sources of supply in crucial industries whose structural characteristics lead naturally to concentration.

Doubtless there are other mixes and variations to this approach. With some fine-tuning, however, the measures outlined hold out the promise to activist policy-makers that the tools exist to strengthen the relative power and influence of a country, while at the same time preserving reasonably stable relations between the various industrial challengers. In this sense, advances in economic realism and neo-mercantilism offer governments hope that they can affect their country's fate rather than casting it to the free-market winds.

See also:

economic nationalism

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economic regions

Economic regions are made up of a limited number of states, counties or cities which share a common geographical space and which are economically interdependent to varying degrees (see INTERDEPENDENCE). Economic regions may take many forms, from supra-national regional trading blocs such as the ECONOMIC COMMUNITY OF WEST AFRICAN STATES (ECOWAS) to supra-continental economic regions such as the newly created ASIA-PACIFIC ECONOMIC COOPERATION FORUM (APEC). Economic regions more commonly refer to sub-national economic regions organized around particular industry clusters, such as the industrial districts of Tuscany or 'technopoles' (Castells and Hall, 1994), such as the Silicon Valley in California.

Economic regions are playing an increasingly significant role in international political economy (IPE). Theorists such as Ohmae (1995) argue that the decline in the influence of nation-states and the GLOBALIZATION of the world political economy has led to the increase in importance of both supra-national and sub-national regions. While supra-national economic regional associations, in the form of trading blocs or development initiatives, have